

*E*valuation



*R*eport

USE OF FEDERAL ACQUISITION REGULATION PART 12  
CONTRACTS FOR APPLIED RESEARCH

Report No. D-2001-051

February 15, 2001

This special version of the report has been revised  
to omit contractor proprietary data.

Office of the Inspector General  
Department of Defense

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### **Acronyms**

CAS	Cost Accounting Standards
DARPA	Defense Advanced Research Projects Agency
FAR	Federal Acquisition Regulation
LMI	Logistics Management Institute
PNM	Price Negotiation Memorandum
RIT	Rapid Improvement Team



INSPECTOR GENERAL  
DEPARTMENT OF DEFENSE  
400 ARMY NAVY DRIVE  
ARLINGTON, VIRGINIA 22202-4704

February 15, 2001

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE FOR ACQUISITION,  
TECHNOLOGY, AND LOGISTICS  
AUDITOR GENERAL, DEPARTMENT OF THE ARMY

SUBJECT: Evaluation Report on the Use of Federal Acquisition Regulation Part 12  
Contracts for Applied Research (Report No. D-2001-051)

We are providing this evaluation report for review and comment. We considered comments from the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics on a draft of this report in preparing this final report.

DoD Directive 7650.3 requires that all recommendations be resolved promptly. The comments from the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics were partially responsive. Therefore, we request additional comments on Recommendations 1. and 2. by April 16, 2001.

We appreciate the courtesies extended to the evaluation staff. Questions on the evaluation should be directed to Mr. John E. Meling at (703) 604-9091 (DSN 664-9091) (jmeling@dodig.osd.mil). See Appendix E for the report distribution. The evaluation team members are listed inside the back cover.

*David K. Steensma*

David K. Steensma  
Deputy Assistant Inspector General  
for Auditing

## Office of the Inspector General, DoD

Report No. D-2001-051

February 15, 2001

(Project No. D2000AE-0272.000)

### Use of Federal Acquisition Regulation Part 12 Contracts for Applied Research

#### Executive Summary

**Introduction.** This report analyzes Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics attempts from 1997 to 2000 to justify the use of Federal Acquisition Regulation (FAR) Part 12, "Acquisition of Commercial Items," contracts for acquiring applied research. Applied research involves the scientific efforts to translate basic research into solutions for broadly defined military needs. The report also analyzes a Logistics Management Institute study, "Using FAR Part 12 to Buy Commercial Services in Applied Research," August 1999. Further, the report discusses a Rapid Improvement Team that the Deputy Under Secretary of Defense (Acquisition Reform) chartered on March 20, 2000, to improve the involvement of commercial firms in the Government research and development process by piloting commercial-like (fixed-price) research and development relationships with a contractor and its technology venture companies.

**Objective.** The primary objective was to evaluate use of FAR Part 12, "Acquisition of Commercial Items," contracts to acquire applied research.

**Results.** The Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Defense Advanced Research Projects Agency have made different attempts over the last 3 years to inappropriately use FAR Part 12 contracts to acquire applied research. The lack of a commercial market and established catalog and market prices for applied research, and difficulties in determining fair and reasonable prices for services that do not exist in the marketplace makes the use of commercial item contracts for applied research inappropriate. The Director, Defense Procurement, and the Defense Contract Audit Agency have advised the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Defense Advanced Research Projects Agency that the use of commercial item contracts for applied research is inappropriate. The Office of the General Counsel also provided the same advice to the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics. DoD has multiple acceptable strategies to engage in applied research with traditional DoD contractors and new contractors that have never performed DoD work. DoD can use FAR contracts and, when appropriate, can waive Cost Accounting Standards and Truth In Negotiations Act requirements. DoD can also use grants, cooperative agreements, and other transactions that are not subject to the FAR and most procurement statutes. Despite these alternatives, the Directorate of Contracting at Fort Huachuca, Arizona, inappropriately awarded the contractor, in August 2000, a FAR Part 12 "firm-fixed-price (variable outcome) contract" for applied research in support of the Defense Advance Research Projects Agency. The contract did not satisfy the statutory definition of a commercial item and the contract type is not defined in the FAR. See the Evaluation Results section for a discussion of our overall evaluation.

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**Summary of Recommendations.** We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics provide guidance to the Rapid Improvement Team and to contracting officers to not use a FAR Part 12 contract to acquire applied research. Guidance should also state that market research, especially verification of prices from sources independent of the offeror, is a key factor in determining whether established market prices exist for research or other commercial services. We also recommend that, if the Under Secretary of Defense for Acquisition, Technology, and Logistics decides to encourage the use of any new type of contract for research and development, it should be defined in the FAR, along with criteria for and limitations on its use.

**Management Comments.** The Director, Defense Procurement, concurred with the recommendations and stated that the Under Secretary would provide guidance on the appropriate contract type for applied research and on the use of market research. The Director stated that the use of the term “firm-fixed-price (variable outcome) contract” is a misnomer and should not be included in the report recommendations. Further, the Director stated that DoD should explore the utility of a new type of contract for research and development under which DoD establishes a fixed amount of funding for the contractor to provide its best efforts toward achieving a desired outcome. If the new contract type has utility, DoD should establish it in the FAR. A discussion of the management comments is in the Evaluation Results section of the report, and the complete text is in the Management Comments section.

**Office of the General Counsel Comments.** On January 11, 2001, the Deputy General Counsel (Acquisition and Logistics) issued a memorandum to the Director, Defense Procurement, Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics, advising that applied research is not a commercial service and not suitable for acquisition under FAR Part 12 procedures.

**Evaluation Response.** The comments from the Director, Defense Procurement, were partially responsive to the recommendations. The Director did not provide an estimated date as to when the Under Secretary of Defense for Acquisition, Technology, and Logistics plans to issue guidance advising that the use of FAR Part 12 contracts for applied research is inappropriate and clarifying the use of market research to determine whether services qualify as commercial items. In response to the Director’s comments, we revised the report to remove the term “firm-fixed-price (variable outcome) contract” from the report recommendation. Further, as of the date of this report, the Under Secretary’s website, which is available to the public, still includes documents that promote the use of FAR Part 12 contracts for applied research and the use of “fixed-price (variable outcome) contracts.” We request that the Under Secretary provide additional comments identifying when guidance will be issued on the appropriate types of contracts that DoD contracting officers can use for applied research and the need for conducting market research to determine whether services qualify as commercial items. We also request comments on when the Office of the Under Secretary will remove documents that promote the inappropriate use of FAR Part 12 contracts for applied research and the use of “fixed-price (variable outcome) contracts” from its website. We request that the Under Secretary provide additional comments by April 16, 2001.

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## Background

**Research and Development.** Federal Acquisition Regulation (FAR) Part 35, “Research and Development Contracting,” states that the primary purpose of contracted research and development programs is to advance scientific and technical knowledge (basic research) and apply that knowledge to the extent necessary to achieve agency and national goals (applied research). Basic research is directed towards increasing knowledge rather than a practical application of that knowledge. Applied research consists of research efforts to translate basic research into solutions for broadly defined military needs, short of major development efforts. The dominant characteristic of DoD applied research is that it be pointed toward specific military needs with a view toward developing and evaluating the feasibility and practicality of proposed solutions and determining parameters. Unlike contracts for supplies and services, FAR Part 35 states that most research and development contracts are directed toward objectives for which the work or methods cannot be precisely described in advance. It further provides that the use of cost-reimbursement contracts is usually appropriate because the absence of precise specifications and difficulties in estimating costs with accuracy (resulting in a lack of confidence in cost estimates) normally precludes using fixed-price contracts for research and development.

**Report of the Price-Based Acquisition Study Group.** The “Report of the Price-Based Acquisition Study Group,” November 15, 1999, that the Under Secretary of Defense for Acquisition, Technology, and Logistics approved, states that high-technology commercial companies purchase research and development, but not in the same way DoD does. The companies typically acquire research and development in one of three ways.

- First, they buy it from themselves by making fixed-price investments into various ventures within the company. In general, these investments have formal, contract-like terms and conditions, are often interdivisional within the same company, involve unique items, and are fixed-price arrangements. The company makes investments in increments; that is, the company funds the investment one step at a time, reexamining the projects periodically to see whether they warrant added investment dollars or should be canceled.
- Second, companies acquire research and development as part of the purchase price of the product in the same way that a consumer acquires research and development by buying a new version of software to run a computer.
- Third, large companies acquire research and development by purchasing other companies. They acquire another company’s products, ongoing research and development, and technical know-how.

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The report found that, unlike commercial companies, DoD is only a buyer and not a supplier or a subcontractor for many military products. Also, the Report of the Price-Based Acquisition Study Group did not state that there was a competitive commercial market for research and development.

Further, the report recommended, as a price-based acquisition tool, the use of “fixed-price (variable outcome) contracts” as the preferred approach for science and technology efforts. However, a number of the DoD Components disagreed with the approach and considered it either as a return to the 1980’s approach of using fixed-price contracts for research and development or a difficult concept to implement.

**Methods to Acquire Research and Development.** Chapter 139 of title 10, United States Code, “Research and Development,” provides DoD the statutory authority to engage in research through a variety of instruments. Section 2358 of title 10 authorizes the use of contracts, cooperative agreements, and grants to engage in research projects. Section 2371 of title 10 authorizes the use of other transactions to carry out research projects.

**Contracts.** Contracts negotiated under FAR Part 15 may be of any type or combination of types that promote the Government’s interest. The objective of the contracting officer is to negotiate a contract type and price that results in reasonable contractor risk and provides the contractor with the greatest incentive for efficient and economical performance. Contracting officers shall also determine that the offered price is fair and reasonable. Unless the price is based on competition or another FAR exception, contracting officers are required to obtain cost or pricing data from the contractor to make a determination as to whether the proposed price is fair and reasonable. Contracting officers are not required to obtain cost or pricing data for acquisitions at or below the Truth In Negotiations Act threshold of \$550,000. The head of the contracting activity can waive the requirement to obtain cost or pricing data in exceptional circumstances, such as if the price can be determined to be fair and reasonable without submission of cost or pricing data. The FAR exempts negotiated contracts from Cost Accounting Standards (CAS) under certain circumstances, to include contracts that do not exceed \$500,000 or the contract types are firm-fixed-price or firm-fixed-price with economic price adjustment. The FY 2000 Authorization Act exempted contracts of less than \$7.5 million if at the time of award the contractor to perform the work has not previously been awarded a CAS contract exceeding \$7.5 million. The Act also allows the DoD to waive CAS in certain circumstances.

**Grants and Cooperative Agreements.** The Secretary of Defense and the Military Departments can engage in basic research and applied research projects through grants and cooperative agreements. Implementing guidance is contained in DoD Regulation 3210.6-R, “DoD Grant and Agreement Regulations,” April 13, 1998. A grant is a legal instrument used to enter into a relationship to transfer a thing of value to the recipient to carry out a public purpose of support or stimulation rather than to acquire property or services for direct benefit or use of DoD. In carrying out the grant purpose, substantial involvement is not expected between DoD and the recipient. A cooperative



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agreement is a legal instrument similar to a grant except that substantial involvement is expected between DoD and the recipient when carrying out the cooperative agreement purpose.

**Other Transactions.** Other transactions are instruments other than contracts, grants, and cooperative agreements used to stimulate, support, or carry out research or prototype projects. Congress authorized DoD to enter into other transactions in 1989 as a way to encourage commercial firms to advance dual-use technology, to broaden the technology and industrial base available to DoD, and to foster new relationships and practices within the technology and industrial base that supports national security. Other transactions are generally not required to comply with statutes and regulations that are applicable to contracts, grants, and cooperative agreements. The application of procurement regulations and statutes, such as the Cost Accounting Standards, the Truth In Negotiation Act, technical data rights, and patent provisions, is discretionary. Other transactions may have fixed-price or cost-type characteristics and may require cost sharing from the contractor. DoD has two types of other transactions: research and prototype. Research other transactions are for basic and applied research and guidance is in DoD Regulation 3210.6-R. Prototype other transactions are for development of prototypes for weapon and other systems and guidance is in a directive-type memorandum that the Under Secretary of Defense for Acquisition, Technology, and Logistics issued on December 21, 2000.

## **Objective**

The primary objective was to evaluate use of FAR Part 12, “Acquisition of Commercial Items,” contracts to acquire applied research. See Appendix A for a discussion of the evaluation scope and methodology and prior coverage related to the objective.

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## **Use of FAR Part 12 Contracts for Acquiring Applied Research**

Elements within the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics and the Defense Advanced Research Projects Agency (DARPA) have made different attempts over the last 3 years to inappropriately justify or use FAR Part 12, “Acquisition of Commercial Items,” contracts to acquire applied research. This condition occurred in spite of advice from the Director, Defense Procurement; the Office of General Counsel; and the Defense Contract Audit Agency and because of misplaced reliance on a flawed study by a consultant. Further, available methods of acquiring research, such as traditional cost and fixed-price contracts, and research other transactions, were considered less desirable alternatives. Recently, a contracting officer at Fort Huachuca, Arizona, inappropriately awarded a contractor, whose company primarily conducts research and development, a FAR Part 12 “fixed-price (variable outcome) contract” for applied research despite the objections of personnel from the Defense Contract Audit Agency and the Inspector General, DoD. Applied research for DoD is devoted in part to developing or meeting a military unique capability or capability that does not exist and does not satisfy the commercial item criteria in the FAR.

### **Requirements for Using FAR Part 12**

FAR Part 12, “Acquisition of Commercial Items,” prescribes policies and procedures for the acquisition of commercial items. It implements the Federal Acquisition Streamlining Act of 1994’s (the Act) preference for the acquisition of commercial items by establishing acquisition policies more closely resembling those of the commercial marketplace. The Act authorized contracting officers to use streamlined contracting procedures as a result of reduced risks to the Government based on influences of the commercial marketplace on contractor pricing and performance. The premise is that commercial items and services are readily available and competition will ensure fair prices and quality. To eliminate Government unique requirements and perceived impediments of commercial contractors, FAR Part 12 eliminates many otherwise standard solicitation provisions, contract provisions, and contract clauses (such as audit access, Cost Accounting Standards, and Truth In Negotiations Act).

DoD contracting officers are authorized to use FAR Part 12 for the acquisition of supplies and services that meet the definition of commercial items in Part 2, “Definitions of Words and Terms,” of the FAR. Based on section 403(12)(F) of title 41, United States Code, “Definitions,” FAR Part 2 defines services as a commercial item if the services are of a type offered and sold competitively in substantial quantities in the commercial marketplace and are based on established catalog or market prices for specific tasks performed under standard commercial terms and conditions. The definition excludes services sold based on hourly rates without an established catalog or market price for specific services performed. The FAR does not define market price. However, the

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Conference Report 104-450 for the National Defense Authorization Act for FY 1996, which added the term “market price” to the definition of “commercial item,” states that “market prices are current prices that are established in the course of ordinary trade between buyers and seller free to bargain and *that can be substantiated from sources independent of the offeror* [emphasis added].”

Two significant cases help clarify the definition of commercial services. These were *Aalco Forwarding, Inc. et seq.* (hereafter *Aalco*), B-277241.9, October 21, 1997, 97-2 CPD 110; and *Environcare of Utah, Inc. v. United States* (hereafter *Environcare*), 44 Fed. Cl. 474, Court of Federal Claims, June 11, 1999. Both cases conclude that market research by the contracting officer provides the basis for determining whether a commercial service with a competitive market and an established catalog or market price exists. In *Aalco*, the Government presented extensive documentation to demonstrate that the services were sold competitively. The Military Traffic Management Command officials provided statements based on their extensive experience in transportation services and extensive market surveys regarding commercial services and terms and conditions in the transportation industry. Examples of corporate contracts for such services were obtained. The published tariffs and exceptions to tariffs for the industry evidenced that transportation services were sold competitively and that there were established prices and terms and conditions for these commercial services. In *Environcare*, the Corps of Engineers issued a solicitation for the removal of five different types of waste, including low-activity radioactive waste, naturally occurring radioactive materials, and hazardous mixed waste. The protester contended that the Corps of Engineers should have issued the solicitation pursuant to FAR Part 12 procedures, as the radioactive waste disposal services constituted a commercial item. The Court held that the disposal services were not a commercial item as market prices could not be substantiated from sources independent of the offeror, and there was no competitive market for the service, or established catalog or market prices for the services.

## **DARPA FAR Part 12 Contracts Awarded in 1997 and 1998**

**FAR Part 12 Contract Awards.** From April 1997 through August 1998, DARPA awarded six contracts, valued at \$8.5 million, using FAR Part 12 procedures for acquiring certain research where commercial industry involvement was of particular interest to DARPA. Attributes of the acquisitions were:

- Broad area announcements were used to solicit innovative ideas and research alternatives in specified technology areas.
- Firm-fixed price contracts were negotiated with milestones crafted around small, incremental technical activities.
- Contracts were incrementally funded, typically on an annual basis.
- Price reasonableness was established using price analysis (certified cost or pricing data were not required).

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- In some cases, transfers among corporate divisions were used by DARPA to “verify” market prices.
  - While contracts did not require cost-sharing, the proposals included commitments of corporate funding.
  - Commercial data rights clauses were used.

**Under Secretary of Defense for Acquisition, Technology, and Logistics**

**Direction.** On December 8, 1997, the Under Secretary of Defense for Acquisition, Technology, and Logistics issued a memorandum to the Secretaries of the Military Departments on “Fixed Price Contracts for Development with Commercial Companies.” As background, the Under Secretary stated that as a result of declining Defense budgets, the Department had seen consolidation of the defense industry so that, in some instances, the Department had only two competitors for DoD requirements. He stated that he believed that DoD could increase healthy competition for DoD requirements by reaching out to creative companies that normally do not compete for DoD contracts. To encourage those companies to play a greater role in satisfying DoD needs, he asked the Military Departments’ support for issuing several solicitations that would be tailored to elicit proposals from those companies. Among the characteristics he specified for the solicitations were:

- Efforts would be for development for which DoD has a valid requirement;
- Efforts must be of sufficiently low risk so offerors can realistically offer firm-fixed prices in a competitive fixed-price environment; and
- Efforts would be solicited on a competitive fixed price basis so there would be no need for submission of any cost or pricing data. *When appropriate* [emphasis added], the contracts should use the terms, conditions, and procedures under FAR Part 12.

To implement this direction, the Under Secretary asked each of the Military Departments to nominate at least one development or major modification requirement using a fixed-price contract. The complete text of the Under Secretary memorandum is in Appendix B.

**Director of Defense Procurement Assessment.** On July 20, 1998, the Director of Defense Procurement issued a memorandum to DARPA concerning the justification for awarding four FAR Part 12 contracts in 1997 and 1998. Based on the information that DARPA provided, the Director concluded that the research and development services on three of the four contracts did not meet the FAR definition of a commercial item.

For the three contracts, the DARPA rationale relied on the research and development services in question being “traded substantially” between each contractor’s research center and related product divisions. The Director stated that such transactions fail to satisfy the requirement of established market prices for specific tasks. The Director stated that when the words “or market” were

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added to the phrase “established catalog or market prices” in section 403(12)(F) of title 41, United States Code, “Definitions,” the accompanying Conference Report, which caused the addition of the phrase, defined market prices as “current prices that are established in the course of ordinary trade between buyers and sellers free to bargain and that can be substantiated from sources independent of the offeror.” The Director concluded that the commercial item definition requires that commercial services be of a type offered and sold in the marketplace in substantial quantities based on established catalog or market prices. Interdivisional transfers alone can not satisfy this definition.

For the fourth contract, the Director stated that she would need further information to render an assessment as to whether the research and development effort met the FAR commercial item definition. Specifically, the Director stated that she would need information on the specific services procured and how DARPA verified that the services were sold competitively, in substantial quantities, in the commercial marketplace, and were based on established market prices for specific tasks. Although additional dialogue between the Office of the Director of Defense Procurement and DARPA occurred, the two offices did not resolve the issue concerning whether the fourth contract met the FAR commercial item definition. The complete text of the Director of Defense Procurement memorandum is in Appendix C.

**Defense Contract Audit Agency Assessment.** The Defense Contract Audit Agency developed a white paper in 1998 that addressed research and development services provided solely to internal customers (that is, sister divisions and affiliate companies). The Defense Contract Audit Agency’s assessment as to whether interdivisional transfers meet the specific criteria of the definition of commercial services follows:

- **Offered and sold competitively.** Companies would have difficulty meeting this criterion. The companies are not competing with outside companies when providing research and development solely within their organization.
- **Substantial quantities in the commercial marketplace.** The Defense Contract Audit Agency observed that the terms “general public” and “commercial marketplace” are used in the definition of commercial item in FAR Part 2. It further noted that earlier versions of FAR Part 15 defined the term “general public” to exclude “sales to affiliates of the offerors . . . .” While the term “commercial marketplace” is not defined in the FAR, it is reasonable to conclude that it includes to some degree, sales to the general public. Based on the previous FAR definition of general public, which has since been deleted, the Defense Contract Audit Agency concluded that interdivisional sales or sales to a company’s “internal customers” do not constitute sales in the commercial marketplace, or otherwise meet the FAR’s criteria for what constitutes a commercial item.
- **Established catalog or market prices.** Although no longer defined in FAR Part 15, “established catalog price” was previously defined as prices recorded in a catalog, price list, schedule, or other

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verifiable and established records that are regularly maintained by the manufacturer or vendor and are published or otherwise available for customer inspection. “Established market price” was previously defined as a price that is established in the course of ordinary and usual trade between buyers and sellers free to bargain and that can be substantiated by data from sources independent of the offeror. (This is substantially the same definition contained in the Conference Committee Report when “market price” was added to the commercial services definition.)

The Defense Contract Audit Agency advised that although it would be difficult for these companies to meet the previously defined criterion for market price, the companies could possibly meet the previously defined criterion for catalog price (although they most likely would not, as the catalog prices would not be published or otherwise available except to other Divisions within the same company).

Accordingly, the Defense Contract Audit Agency concluded that companies are not selling research and development efforts that meet the definition of a commercial service as defined in FAR Part 12 when offering research and development services previously provided only to affiliates.

## **Logistics Management Institute Study**

In August 1999, the Logistics Management Institute (LMI) published a report on “Using FAR Part 12 to Buy Commercial Services in Applied Research.” The Office of the Deputy Under Secretary of Defense (Acquisition Reform) tasked LMI to conduct the study. In the report, LMI stated why it believed that DoD can and should use FAR Part 12 to acquire applied research from contractors. Our review and analysis of the LMI study showed it was superficial and lacked apparent legal basis for DoD use of FAR Part 12 contracts for applied research. A discussion of the LMI study and our assessment follows.

**Service of a Type.** LMI stated that “whether it be product research or process research, the type of research found in the marketplace is generally similar to that contracted for by the Government.” LMI compared the definition of “applied research” included in the FAR to that used by the National Science Foundation to show that “the type of research found in the marketplace is similar to that contracted for by the Government.”

The LMI comparison of FAR and National Science Foundation definitions of applied research and conclusion that Government and commercial sector research are identical are flawed. LMI failed to acknowledge that applied research conducted for DoD is for the specific purpose of fulfilling military needs. DoD conducts applied research to meet a military need that does not exist in the commercial market. Acquisition of such services does not constitute commercial services as defined by FAR Part 12. While such research may

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eventually have application in the commercial sector, the reason that DoD enters into agreements with firms to conduct applied research is to meet one or more needs of the military.

**Sold Competitively in Substantial Quantities in the Commercial Marketplace.** LMI stated that commercial research and development totals \$113.5 billion annually in the U.S. economy. LMI stated that this figure is nearly twice the federal expenditure and represents substantial quantities sold. LMI stated that it could not distinguish precisely the portion of research that is sold competitively. However, LMI believed a conservative estimate of research and development sold competitively would be 10 percent or \$11.4 billion of the \$113.5 billion sold annually.

The LMI conclusion regarding the extent of commercial research and development is without basis. The LMI report does not explain or substantiate its estimate of the amount of research and development sold competitively. It does not even provide examples of companies that regularly provide such services in the commercial marketplace.

The definition of commercial services requires that such services be offered and sold competitively in substantial quantities in the commercial marketplace. The definition presumes that there is a competitive marketplace for such services. The mere fact that such services are offered by only one company does not prove that such a marketplace exists, or that such services are sold competitively in substantial quantities. One would assume that, if DoD required applied research regarding certain applications to meet military needs, DoD should be able to determine the existence of such services, as well as their prices and past sales, based upon a review of trade journals and the marketing literature published by various competitors which routinely offer and perform such services. However, as DoD is acquiring applied research for specific military applications, it is doubtful that market research would reveal that such services are even offered, let alone priced, in the commercial marketplace.

This is not to say that DoD could not procure such research. In fact, DoD procures much research from industry. It is simply not acquired as a commercial service.

**Based on Established Catalog or Market Prices.** LMI asserted that prices paid for research in the general marketplace are based on “market prices.”

The LMI conclusion is deficient because it does not provide examples where applied research was of a type offered and sold competitively in the commercial marketplace and is based on established catalog or market prices. Furthermore, independently verifiable prices for the conduct of applied research from a number of sources must be obtained to establish that market prices exist for such services. Because of the nature of DoD’s applied research needs, market prices related to research would have to be verified on a case-by-case basis to determine if such services fit the definition of commercial services.

**For Specific Tasks Performed.** LMI stated that an argument could be made that all basic research generally conforms to the same basic steps contained in

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the scientific method of research: perform initial observation, gather information, title the project, state the purpose of the project, identify variables, make hypothesis, design experiments, do the experiments and record data, record observations, perform calculations, summarize results, and draw conclusions. LMI stated that while applied research is more oriented toward specific product development, it involves many of the same steps of basic research.

Research is not frequently procured or paid for on the basis of repetitive steps such as designing an experiment and then conducting the experiment. An end product, such as a study, is the key deliverable. Alternately, research is acquired on a level-of-effort basis and procured on a cost-type basis, or, where the level of risk is determined to be low for the effort, procured on a firm-fixed-price basis. This is not the same as buying an item that is readily available in the commercial marketplace out of a catalog or that has an established market price.

## **Director of Defense Procurement and Office of General Counsel Comments on LMI Study**

On October 26, 1999, the Director of Defense Procurement, in coordination with the Office of the Deputy General Counsel (Acquisition and Logistics), issued a memorandum to the Under Secretary of Defense for Acquisition, Technology, and Logistics concerning the LMI Study. The memorandum stated that conducting research under FAR Part 12 requires a statutory change because the law states that commercial services must have “catalog or market prices for specific tasks.” The memorandum advised that while LMI may endorse the policy of using Part 12 for the conduct of applied research, DoD is without legal authority to pursue this alternative. The memorandum observes that the LMI interest appeared to be leveraging commercial research and development through whatever means were available and repeatedly mentioned attracting commercial firms that would not otherwise do business with the Government. The memorandum went on to state that this objective is already served by a variety of assistance and acquisition instruments. Specifically, grants, cooperative agreements, and other transactions have been tailored for this objective, and provide greater flexibility than FAR Part 12 contracts. The memorandum also stated that if it is decided that applied research, as a class, should be bought under FAR Part 12, that decision in all likelihood would severely limit the use of other transactions for research. The complete text of the memorandum is in Appendix D.

## **Rapid Improvement Team**

**Charter.** On March 20, 2000, the Deputy Under Secretary of Defense (Acquisition Reform) chartered a rapid improvement team (RIT) to identify a mutually acceptable approach for contracting for research and development between DoD and a contractor. The RIT was challenged to facilitate the involvement of commercial firms in the Government research and development



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process. The RIT was to place special emphasis on emerging or start up companies by piloting commercial-like (fixed-price) research and development relationships with the contractor and its technology venture companies (spin-offs). The RIT was furnished the LMI Study as a basis for using FAR Part 12 contracts for acquiring applied research. However, the RIT was not provided the October 26, 1999, memorandum from the Director, Defense Procurement.

**Use of Fixed-price Contracts.** The RIT identified methods that could be used for fixed-price contracting for research and development efforts. For research and development efforts that meet the definition of a commercial item in FAR Part 2, the contractor could use FAR Part 12 for contracting with DoD organizations. For research and development efforts not meeting the definition for a commercial item, the contractor and its spin-offs could use the other transaction authority, a fixed-price level-of-effort contract, or a time and materials contract.

The contractor has performed research and development work with DoD for decades. In FYs 1997 through 1999, the DD Form 350 (Individual Contracting Action Report) database showed that DoD awarded the contractor 127 contract actions valued at \$93.3 million. Of the 127 contract actions, 118 actions, valued at \$92.9 million, were cost-based, which is 99.5 percent of the total dollars awarded. In addition, the DoD awarded the contractor one grant valued at \$0.5 million, one cooperative agreement valued at \$1.3 million, and the contractor participated on two other transactions valued at \$15.0 million during the same 3-year period.

DARPA proposed that the RIT use a contractor applied research proposal that was competitively selected against a broad area announcement as the pilot case.

On February 10, 2000, DARPA published a broad area announcement for Human Identification at a Distance. The 1997 Defense Science Board's Summer Study Task Force Report, "DoD Responses to Transnational Threats," stated that United States facilities needed advanced technologies for enhanced and extended perimeter security. The goal of the Human Identification at a Distance program is to develop and demonstrate advanced surveillance methods that will automatically detect, recognize, and identify individuals (cooperative, noncooperative, and uncooperative) from a distance and alert operators to potential security concerns. DARPA received 72 proposals. Included in the 72 proposals were 3 proposals for applied research efforts involving iris scans at a distance. The technical evaluation committee determined that two of the iris scan proposals were technically acceptable and decided to fund the contractor proposal on "Iris Recognition at a Distance," using the evaluation criteria in the broad area announcement. Because of funding limitations, DARPA had the contractor downscope the proposed contract statement of work from the proposed \$2.2 million to \$1.0 million, and requested the Directorate of Contracting at Fort Huachuca, Arizona, to negotiate and award a FAR Part 12 contract to the contractor.

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## Use of FAR Part 12 for an Applied Research Effort

**Comparison of Applied Research Effort to FAR Part 12 Requirements.** The contracting officer at Fort Huachuca inappropriately awarded, effective August 31, 2000, a FAR Part 12 “fixed-price (variable outcome) contract” to the contractor for an applied research effort that did not satisfy the definition of a commercial item. The contract was awarded over the objections of RIT team members from the Offices of the Defense Contract Audit Agency and the Inspector General, DoD. The RIT team member from the Office of the Director of Defense Procurement had not provided an official Director, Defense Procurement, position on the proposed approach to contracting with the contractor before hearing that the contracting officer had awarded the contract. Specifically, the contracting officer was not able to demonstrate that conduct of applied research was:

- Of a type offered and sold competitively. The contractor had performed similar research in the same general scientific area on five commercial contracts.

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The contractor performed the research on a very discreet, sole-source basis, and its payoff is obtaining rights to use the research in other lines of business that will not compete with the customer. The identity of the customers is proprietary. Customers do not want competitors to know they contracted for research with the contractor. Further, two of the five contractor contracts reviewed were contracts with the contractor’s spin-off companies that do not qualify as sales in the commercial marketplace. This “market” is the antithesis of the spirit of the competitive marketplace suggested in the commercial item definition by Congress. Further, the contractor had not offered and sold competitively an applied research effort in the commercial marketplace that was similar in scope to the military unique research objective.

- Sold in substantial quantities in the commercial marketplace. The contracting officer believed that the substantial quantity requirement was met because the contractor had sold similar research in the same general scientific area on the five commercial contracts. These contracts were not concluded or sold in a commercial marketplace but on a confidential sole source basis. Furthermore, the contractor did not provide information on any commercial solicitations it had competitively bid on to perform research. A sole-source and unpublished sale does not satisfy the requirement for sales of substantial quantities in the commercial marketplace. Further, because of the military unique research objective in the subject proposal statement of work, the contractor had not sold substantial quantities of this type of research in the commercial marketplace.

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\*Proprietary data deleted.

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- Based on established catalog or market prices for specific tasks performed. The contractor provided its five contracts in order to establish market prices and advised the RIT of the process used to determine costs to support the prices in its proposal. The contractor did not provide an established catalog for the proposed research effort. DARPA and the contracting officer believed that “market prices” were established by the five commercial contracts that were concluded in the ordinary course of business. These prices at best were negotiated on a sole-source, proprietary basis, without full and open competition. They cannot be verified through independent sources. Trade journals or similar market research information, to include competitive market prices for similar research, were not reviewed to establish catalog or market prices for the applied research effort. Unlike the *Aalco* case, there were no specific tasks with catalog or market prices for the applied research effort.

The contractor’s price is nothing more than its price, not a market price. Similarly, its costs or proprietary data, which support its prices, do not constitute established catalog or market prices. The contractor’s internal hourly rates for employees selected to do the job at an estimated number of hours, which data are not disclosed publicly, do not provide a basis for determining market prices. The contractor’s proposed price is not a “market price” which can be substantiated by independent sources.

**Fair and Reasonable Price.** For cost and certain other contracts, contractors are subject to a variety of statutes and regulations governing pricing and negotiation. Absent competition, the Government’s primary means of ensuring that proposed costs are realistic and allowable and that services are acquired at a fair and reasonable price include contracting officers imposing the Cost Accounting Standards, the FAR cost principles, and the Truth In Negotiations Act requirements in contracts. The Government also reserves the right to audit a contractor’s books, accounting procedures, and other data to ensure compliance with these requirements, and to adjust a contract’s price for noncompliance.

Contracting officers do not need to impose these requirements in contracts for products and services that meet the definition of a commercial item in FAR Part 2 when awarding contracts using FAR Part 12 procedures. The contractor did provide the contracting officer a proposal that listed various cost elements, including labor hours and rates, fringe benefits, overhead, consultant costs, general and administrative expense, and fee (or profit), as well as a proposed total price. The contractor subsequently lowered its proposed price. As part of contract negotiation, the contractor offered the Government a price lower than its typical commercial price.

The contracting officer’s price negotiation memorandum (PNM) includes a section on price analysis. While the contractor had submitted various cost elements in its proposal, the PNM does not reveal an analysis or comparison of those elements to other contract or market prices. Rather, the contracting officer reviewed a fully burdened rate for a research scientist and compared it

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with burdened rates for other research and development efforts awarded by Fort Huachuca. Two rates for efforts with Hewlett Packard are specifically mentioned in the PNM, including a data storage research effort. With respect to material costs, the PNM observed that they were based on quotes, catalog prices, and other data, and that the contractor would purchase the equipment on a competitive basis. The PNM does not indicate that the data were verified or otherwise compared to available contract, catalog, or market prices. Because of a discount offered by the contractor of slightly more than half of its proposed material costs, the PNM points out that the Government would not retain title to equipment purchased by the contractor in performance of the contract.

The contracting officer said that Government technical personnel would make a subjective determination regarding the contractor's performance before payments would be made based on the payment milestones specified in the contract.

Using the above techniques may not provide assurance that the proposed prices are fair and reasonable. While the contracting officer may be able to independently verify the loaded labor rate against other efforts at Fort Huachuca, this comparison is narrow in scope and appears to be unrelated to the DARPA applied research effort. Furthermore, comparison of the fully loaded labor rate may be meaningless as it is based on a number of apparently unanalyzed and different cost elements ranging from costs for direct labor, fringe benefits, overhead, material, general and administrative expense, and fee, which may vary from company to company, and are dependent on the requirements of different research efforts. The comparison was also apparently limited to efforts awarded by the Fort Huachuca Directorate of Contracting. One of the two Hewlett Packard efforts in the PNM pertained to a data storage research project. The DARPA effort is being acquired on a "fixed-price (variable outcome) contract" for an applied research project that has never been performed before and, therefore, is unique. A comparison of loaded labor rates with different requirements for other research projects for price reasonableness purposes is problematic and may be unreliable. One unfortunate consequence of determining that the DARPA effort is a commercial service is that it makes it unlikely that DoD will have access to the contractor's cost elements, such as its proprietary internal labor, overhead, and profit rates, for determining price reasonableness in future contracts.

The definition of commercial services in FAR Part 2 specifically excludes services sold based on hourly rates without a fixed catalog or market price for a specific service. The contracting officer's price analysis is limited to burdened hourly labor rates and does not discuss catalog or market prices for specific research. The analysis appears to further support the conclusion that the applied research in support of the DARPA effort does not conform to the FAR definition and thus is not a commercial service.

The contractor agreed to participate in the RIT because it wanted to address barriers in cost-reimbursable type contracts that make Government business less appealing than commercial business for high-technology companies. The contractor identified those barriers to include:

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- the burdens and penalties of the Truth In Negotiation Act requirements used to determine fair and reasonable prices on cost type contracts;
  - Bayh-Dole Act requirements on intellectual property and technical data rights requirements;
  - FAR cost principles used to determine allowable costs on cost-type contracts; and
  - FAR Part 15, "Contracting by Negotiation," fee (profit) limitations of not to exceed 15 percent for cost type research and development contracts. The contractor stated that it would like to earn the same \* fee on its Government research contracts that it earns on its commercial research contracts.

From its proposals on cost-type contracts, the contractor voluntarily deleted as unallowable about \* from overhead costs and about \* from general and administrative costs on its business cost base in 1998. The statutory and regulatory policies regarding unallowable costs are based, in part, on the recognition that the DoD and the taxpayer receive no benefits from unallowable costs the contractor and other contractors incur.

The contractor proposed an average fee of \* in FY 1999 for its DoD cost-type contracts. After deducting this from the combined cost of the contractor's profit and potentially unallowable costs on this commercial fixed-price type contract, the use of FAR Part 12 procedures may in the future result in DoD receiving \* less research.

For this contract, the contractor offered DoD a \$103,423 (9.4 percent) discount from the proposed amount of \$1,103,425. This brought the price to \$1,000,002. Since the discount was offered, the contracting officer stated in the price negotiation memorandum that the Government would consider this as a reduction in the contract price, and, therefore, would not retain title to the equipment purchased during the performance of the effort. The contractor will purchase about \$197,000 of scientific and technical equipment. Under a cost-type contract, the Government would obtain title to the equipment. On this contract, the contractor retains title to the equipment and can charge the DoD for use of the equipment on future contracts. The contracting officer believes the \$103,423 discount was worth the cost of the equipment. Because the contractor has been afforded the opportunity to include unallowable costs, and a higher fee than in cost contracts for research and development efforts, we believe the contracting officer would have been able to negotiate a better price had she used a cost-type contract for this effort.

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\*Proprietary data deleted.

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**“Firm-Fixed-Price (Variable Outcome) Type Contract.”** FAR Part 16, “Types of Contracts,” states that a firm-fixed-price contract results in a price that is not subject to any adjustment on the basis of the contractor’s cost experience in performing the contract. Implicit in a firm-fixed-price contract is the understanding that for the firm-fixed-price, the contractor will deliver what the Government contracted for, that is, a firm-fixed-price that the Government will pay for a fixed outcome. This contract type places the contractor at maximum risk and responsibility for all costs and resulting profit or loss. Further, the contracting officer at Fort Huachuca used a “firm-fixed-price (variable outcome) contract,” which is a type of contract not defined in FAR Subpart 16.2, “Fixed-Price Contracts.”

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After analyzing the fixed-price contract for this research effort and the contractor’s commercial contracts, it is easy to understand why other contracting officers chose cost-plus-fixed-fee contracts for 99.5 percent of the research efforts with the contractor. They chose cost-plus-fixed-fee contracts because that was the appropriate contract type for most research efforts.

**Contracting Officer Basis for Using FAR Part 12.** The contracting office did not perform the required market research to determine whether the contractor’s contract would qualify as a commercial service. The contracting officer provided the following rationale for why she believed the use of a FAR Part 12 contract-type was appropriate:

- **Of a type offered and sold competitively.** The contracting officer referred to the five proprietary commercial contracts that the contractor provided for review to support her determination that the proposed research effort was of a type offered and sold competitively. As indicated earlier, use of contractor proprietary commercial contracts that were not disclosed publicly and were negotiated on a sole source basis does not provide a basis for a determination that the research is of a type offered and sold competitively. The contracting officer should perform market research and be able to show that the research is readily available from at least two, and preferably several, companies.

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\*Proprietary data deleted.

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- **Sold in substantial quantities in the commercial marketplace.** The contracting officer cited the five proprietary commercial contracts that the contractor provided for review as the basis for making her determination that the contractor had sold substantial quantities of similar research in the commercial marketplace. The sole-source, private, and unpublished sales do not satisfy the requirement for sales of substantial quantities in the commercial marketplace. Further, because of the research objective in the subject proposal statement of work, the contractor had not sold substantial quantities of this type of research in the commercial marketplace.
  - **Based on established catalog or market prices for specific tasks performed.** The contracting officer only used the broad area announcement as market research, and otherwise relied on the contractor's five proprietary commercial contracts to determine that the applied research constituted a commercial item. Her determination and findings in support of her commercial item determination do not indicate that she conducted a review of catalog or market prices for applied research generally, or for the DARPA-specific military application. Consequently, her decision was not based on any publicly available information to independently establish that applied research is commonly purchased in the competitive market based on established catalog or market prices, or that there are established prices for the DARPA-specific applications. At best, the determination was based on the proprietary cost and pricing data furnished by the contractor. Such data, however, do not establish catalog or market prices, but rather, only the contractor's proposed price and past costs. Moreover, those prices and cost elements have not been publicly disclosed or the result of competition in the commercial marketplace. The contractor stated that, by mutual agreement, the identity of its customers is usually kept confidential because the existence of the customers' research and development efforts is proprietary and market sensitive information. As suggested in the Conference Committee report and in the *Environcare* case discussed earlier, market prices should be based on sources that are independent of the offeror. The determination and findings fail to identify any other commercial companies or trade literature which might independently establish market prices for the specific tasks to be performed.

In summary, the contracting officer's determination that it was permissible to use a FAR Part 12 contract type to contract for the contractor's applied research effort was not appropriate. Specifically, the contracting officer did not demonstrate that the applied research effort met the FAR Part 2 definition of a commercial service; that is, the services are of a type offered and sold competitively in substantial quantities in the commercial marketplace and are based on established catalog or market prices for specific tasks performed under standard commercial terms and conditions. Also, the contracting officer used a contract type not authorized for use under FAR Part 12. Furthermore, based on the information that the contracting officer provided, it would have been more

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appropriate to have chosen another type of contract, such as time-and-materials or level-of-effort cost-type contract, to acquire the contractor's applied research effort.

## **Effect of Using FAR Part 12**

The inappropriate use of FAR Part 12 procedures and firm-fixed-price contracts for applied research can have numerous effects.

- Only firm-fixed-price type contracts may be awarded. Contractors are required to assume a disproportionate risk if experiments or tests need to be redone or modified in connection with applied research projects. These possibilities exist given that each effort is unique and the various experiments or tests may provide unexpected results or not provide adequate data.
- Use of a firm-fixed-price type of contract is likely to result in the DoD getting less research for its research and development dollars.
- Contractors can include in their price costs that are not allowable in the FAR.
- The Government deprives itself of audit access to contractor records that would assist the contracting officer in determining whether proposed prices are fair and reasonable, particularly for future applied research contracts, and for verifying that the Government received the services for which it paid.
- Contracting officers may not be able to independently verify the reasonableness of proposed prices because of the unique nature of applied research for military applications.
- Contractors can earn more than the maximum 15 percent fee normally allowed for research and development and DoD would not be aware of the amount of the contractor's profit.
- Contractors do not have to furnish cost and pricing data. DoD must rely on other pricing information in order to determine if contractor prices are fair and reasonable. This is a difficult task to perform, particularly when each applied research effort is unique.
- The Government's rights to technical data may be unnecessarily restricted. FAR Part 12 states that the Government will only require that data customarily provided to the public. Where research is Government funded, the Government may have an interest in obtaining greater rights.

## **Other Alternatives for Performing Research**

For applied research efforts that do not satisfy the definition of a commercial item in FAR Part 2, it would be more appropriate for contracting officers to use other alternatives for engaging in applied research. Specifically, DoD has



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multiple acceptable strategies for engaging in applied research that include cost and fixed-price contracts under FAR Part 15, “Contracting by Negotiation,” cooperative agreements, grants, and other transactions for research as discussed earlier. To attract new contractors that are averse to doing business with DoD, contracting officers can use other transactions that are not subject to the FAR and most procurement statutes.

## **Improvements in Procurement of Services**

Section 821 of the FY 2001 National Defense Authorization Act provided the Department an incentive to improve contracting for services. The Section established a preference for the use of performance-based contracts for services. As an incentive to do more performance-based contracting, the Section allows DoD to use FAR Part 12 contracting procedures for service contracts, even if the service being acquired does not meet the definition of “commercial services,” if:

- The contract or task order is valued at \$5 million or less;
- The contract or task order sets forth specifically each task to be performed and, for each task:
  - defines the task in measurable, mission-related items;
  - identifies the specific end products or output to be achieved; and
  - contains a firm-fixed price; and
- The source of the services provides similar services to the general public under terms and conditions similar to those offered to the Federal Government.

Personnel in the Office of the Deputy Under Secretary of Defense (Acquisition Reform) have advocated use of the Section 821 authority for research and development contracting because it would not require a determination that the services are commercial. The provisions of the Section would not apply to a “firm-fixed-price (variable outcome) contract” like the research contract with the contractor because most research and development efforts do not meet the requirement for specific end products or outputs. Applied research by its very nature of pursuing applications for something that does not exist in the marketplace generally cannot meet the requirements of the Section.

## **Congressional Intent for Acquiring Items**

The legislative history for the Federal Acquisition Streamlining Act emphasizes that the use of commercial item acquisitions will lower the Government’s cost of doing business. This is accomplished by an increasing reliance on the use of the commercial marketplace for obtaining commercially developed items and

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adopting commercial practices. Senator Carl M. Levin’s discussion with respect to nondevelopmental items is a further example of the congressional impetus to support commercial item acquisitions. He stated that:

It only makes sense that products that are already in use . . . are less expensive and easier to purchase than government-unique items. The acquisition . . . can lower initial purchase costs by reducing or eliminating the need for research and development. Acquisition lead-time can be reduced . . . . Because the product is already developed and has been shown to work, the need for detailed design specifications and extensive testing is also reduced . . . .

The House included commercial services in the definition of commercial items and recognized that such services are “increasingly developed, marketed and sold to the general public as a stand-alone commercial product . . . .” (House Report No. 103-545, June 17, 1994 [to accompany HR 2238])

The acquisition of applied research does not conform to the congressional intent regarding commercial items. Such research is devoted to applications which are usually unique to the military and are unknown or untested. There is no “product” that already exists or is sold to the general public as a “stand-alone” service. If anything, the contractor’s experience, for example, is based on discrete sales that are shielded insofar as possible from public scrutiny. Moreover, the legislative history appears to be directed towards the acquisitions of products that result from research, and to stand-alone services, not the research services that develop products.

The benefits of using FAR Part 12 procedures include obtaining access to readily available commercial products that have been competitively sold in the commercial marketplace. These products or services have already been developed. The Government can rely on the competitive marketplace to a large extent in ensuring that it obtains fair prices for such goods and services. These conditions do not exist with respect to the acquisition of applied research.

## **Conclusion**

DoD should not expend further effort trying to engage in applied research using FAR Part 12. The conduct of applied research does not generally fall under the statutory definition of commercial services. Review of available information shows that use of FAR Part 12 procedures to purchase applied research may also result in DoD getting less research for each dollar expended. Further, Congress has granted DoD flexibility to waive the Cost Accounting Standards and Truth In Negotiations Act requirements for contracts and to use other transactions that are not subject to the FAR and procurement statutes to attract and perform research with nontraditional DoD contractors. Further, the Office of the Under Secretary of Defense for Acquisition, Technology, and Logistics, approved a report that advocated, as a price-based acquisition tool, the use of “fixed-price (variable outcome) contracts” as the preferred approach for science and technology efforts. However, a number of the DoD Components disagreed

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with the approach and considered it either as a return to the 1980's approach of using fixed-price contracts for research and development or a difficult concept to implement. If the Under Secretary of Defense for Acquisition, Technology, and Logistics decides to encourage the use of a new type of contract for research and development under which a fixed amount of funding is established for the contractor to provide its best efforts toward achieving a desired outcome, such as a "firm-fixed-price (variable outcome) contract" used by Fort Huachuca, then the new contract type needs to be established in the FAR, along with criteria for and limitations on its use.

## **Management Comments on the Finding**

The Director, Defense Procurement, provided clarifying comments and recommended changes to selected statements in the report, which we made, as deemed appropriate. The complete text of those comments is in the Management Comments section of this report.

## **Deputy General Counsel (Acquisition and Logistics) Comments on the Use of FAR Part 12**

In light of the draft report, the Deputy General Counsel (Acquisition and Logistics), Office of the General Counsel, issued a memorandum, "Use of FAR Part 12 to Buy Research and Development," January 11, 2001, to the Director, Defense Procurement, advising that the use of commercial item contracts for applied research is inappropriate. He stated that, even though his office supports the use of FAR Part 12 for research-related services that meet the definition of commercial services, the conduct of applied research is not a commercial service because the primary objective of research and development is to advance the state of scientific knowledge that does not exist in the marketplace. Therefore, he concluded that applied research is not suitable for acquisition under FAR Part 12.

## **Recommendations, Management Comments, and Evaluation Response**

**Revised Recommendation.** In Recommendation 2. of the draft report, we referred to a "firm-fixed-price (variable outcome) contract" as an example of the type of new contract that DoD should establish in the Federal Acquisition Regulation if it decides to encourage the use of a new type of contract for research and development under which a fixed amount of funding is established for the contractor to provide its best efforts toward achieving a desired outcome. In response to the draft report, the Director, Defense Procurement, objected to the reference to the "firm-fixed-price (variable outcome) contract" in the recommendation. The Director stated that, although the label has been used, the label is a misnomer, and should not be perpetuated by being included in a recommendation that becomes a tasking. She stated that the concept is similar to that of a cost-reimbursement completion type of contract, except that it is the

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deliverable, rather than the amount to be paid, that is subject to adjustment. In firm-fixed-price contracts, both the price and the deliverable are “fixed.” Consequently, we revised the recommendation.

**We recommend that the Under Secretary of Defense for Acquisition, Technology, and Logistics:**

**1. Provide guidance to the Rapid Improvement Team and DoD contracting officers to:**

**a. Not use a commercial item contract (Federal Acquisition Regulation Part 12, “Acquisition of Commercial Items”) to acquire applied research.**

**Management Comments.** The Director, Defense Procurement, concurred, stating that the Under Secretary of Defense for Acquisition, Technology, and Logistics will provide guidance on the appropriate contract types to use for applied research. The complete text is in the Management Comments section of this report.

**Evaluation Response.** The Director’s comments did not address when the Under Secretary of Defense for Acquisition, Technology, and Logistics would provide RIT team members and DoD contracting officers with guidance concerning the inappropriate use of FAR Part 12 contracts to buy applied research. As of the date of this report, the RIT team members were still under the impression that the use of FAR Part 12 contracts for applied research was acceptable to the Under Secretary of Defense for Acquisition, Technology, and Logistics. Further, the Under Secretary’s website still contains information about the RIT, which promotes the use of FAR Part 12 contracts for applied research. Consequently, we request that the Under Secretary provide additional comments addressing when his office will:

- provide guidance to RIT team members and DoD contracting officers concerning the inappropriate use of FAR Part 12 contracts to buy applied research and
- remove from the Under Secretary’s website information about the RIT that promotes the use of FAR Part 12 contracts for applied research.

**b. Clarify that market research, especially verification of market prices from sources independent of the offeror, is a key factor in determining whether services qualify as commercial items.**

**Management Comments.** The Director, Defense Procurement, concurred with the recommendation.

**Evaluation Response.** The Director’s comments did not provide an estimated date as to when the Under Secretary of Defense for Acquisition, Technology, and Logistics would issue the recommended guidance. Therefore, we request

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that the Under Secretary provide additional comments addressing when his office will issue clarifying guidance discussing market research as a key factor in determining whether services qualify as commercial items.

**2. Establish in the Federal Acquisition Regulation any new type of contract for research and development, along with criteria for and limitations on its use, before encouraging its use.**

**Management Comments.** The Director, Defense Procurement, agreed in principle with the recommendation. The Director stated that DoD should explore the use of a new contract type for research and development under which DoD establishes a fixed amount of funding for the contractor to provide its best efforts towards achieving a desired outcome. The Director added that, if the new contract type has utility, it should be established in the Federal Acquisition Regulation, along with criteria for and limitations on its use.

**Evaluation Response.** We agree with the Director that the use of the term “firm-fixed-price (variable outcome) contract” is a misnomer and should not be perpetuated. However, on November 29, 2000, the Under Secretary of Defense for Acquisition, Technology, and Logistics issued a memorandum about price-based acquisition. The memorandum promoted the use of “fixed-price (variable outcome) contracts” for research and is still available to the acquisition community and the public at the Under Secretary’s website. Therefore, we request that the Under Secretary provide additional comments advising when his office will remove from his website documents promoting the use of “fixed-price (variable outcome) contracts,” a contract type that is a misnomer.

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# Appendix A. Evaluation Process

## Scope and Methodology

We conducted this evaluation from April 2000 through October 2000 and reviewed documentation dated from July 1998. To accomplish the evaluation objective, we:

- Participated on Rapid Improvement Team offsite with Government acquisition and regulatory officials and contractor officials on April 19-21, 2000, and July 26, 2000;
- Reviewed the broad area announcement in the Commerce Business Daily that was related to the DARPA pilot applied research project;
- Reviewed requirements in section 403 of title 41, United States Code, "Definitions," and the FAR concerning authority for using FAR Part 12, "Acquisition of Commercial Items;"
- Reviewed the Federal Acquisition Streamlining Act of 1994 and its legislative history;
- Reviewed other requirements in the FAR to include FAR Part 15, "Contracting by Negotiation," FAR Part 16, "Types of Contracts," and FAR Part 35, "Research and Development Contracting;"
- Reviewed DoD Regulation 3210.6-R, "DoD Grant and Agreement Regulations," April 13, 1998, concerning the use of grants, cooperative agreements, and other transactions for engaging in applied research;
- Reviewed Logistics Management Institute study on "Using FAR Part 12 to Buy Commercial Services in Applied Research," August 1999;
- Reviewed Conference Report 104-450 that accompanies the National Defense Authorization Act for FY 1996, Conference Report 106-945 that accompanies the National Defense Authorization Act for FY 2001, and Section 821 of the Act;
- Reviewed *Aalco Forwarding, Inc. et seq.*, B-277241.8.9, October 21, 1997, 97-2 CPD 110; and *Environcare of Utah, Inc. v. United States*, 44 Court of Federal Claims 474, June 11, 1999;
- Reviewed Director, Defense Procurement, memorandum, "Fixed Price Contracts for Development with Commercial Companies," July 20, 1998; and Director, Defense Procurement, memorandum, "LMI Report on Using FAR Part 12 to Buy Research," October 26, 1999;

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- Reviewed the conference report, “Enactment of Provisions of H.R. [House of Representatives] 5408, the Floyd D. Spence National Defense Authorization Act for Fiscal Year 2001,” October 6, 2000; and
  - Met with DARPA and Army contracting officials to review documentation to determine whether the contractor’s applied research proposal satisfied the definition of a commercial service in FAR Part 2, “Definitions of Words and Terms.”

**Evaluation Standards.** We conducted this program evaluation in accordance with standards issued by the Inspector General, DoD.

**Use of Computer-Processed Data.** We did not rely on computer-processed data to develop conclusions on this evaluation.

**Contacts During the Evaluation.** We visited or contacted individuals and organizations within DoD and the contractor. Further details are available on request.

**DoD-Wide Corporate Level Government Performance and Results Act Goals.** In response to the Government Performance and Results Act, the Secretary of Defense annually establishes DoD-wide corporate level goals, subordinate performance goals, and performance measures. This report pertains to achievement of the following corporate level goal.

**FY 2001 DoD Corporate Level Goal 2:** Prepare now for an uncertain future by pursuing a focused modernization effort that maintains U.S. qualitative superiority in key warfighting capabilities. Transform the force by exploiting the Revolution in Military Affairs, and reengineer the Department to achieve a 21st century infrastructure. **(01-DoD-2)**

**General Accounting Office High-Risk Area.** The General Accounting Office has identified several high-risk areas in DoD. This report provides coverage of the DoD Weapon Systems Acquisition high-risk area.

## **Prior Coverage**

During the last 5 years, the General Accounting Office; the Inspector General, DoD; and the Military Department audit agencies have not issued reports specifically addressing the evaluation objective.

# Appendix B. Under Secretary of Defense for Acquisition and Technology, Memorandum of December 8, 1997



ACQUISITION AND  
TECHNOLOGY

THE UNDER SECRETARY OF DEFENSE  
3010 DEFENSE PENTAGON  
WASHINGTON, D.C. 20301-3010



MEMORANDUM FOR SECRETARIES OF THE MILITARY DEPARTMENTS  
ATTENTION: SERVICE ACQUISITION EXECUTIVES

DEC 08 1997

SUBJECT: Fixed Price Contracts for Development with  
Commercial Companies

As a result of declining defense budgets, we have seen consolidation of the defense industry so that now, in some instances, we have only two competitors for our requirements. I believe we can increase healthy competition for our requirements by reaching out to creative companies that normally do not compete for DoD contracts.

In recent years, many of the cutting edge advances in technology have been made by such companies. While their prices and quality are certainly competitive, often they prefer not to do business in a Government cost reimbursement environment because of the unique auditing and general oversight associated with cost reimbursable contracts. In order to encourage these companies to play a greater role in satisfying defense needs, I ask your support for issuing several solicitations that would be tailored specifically to elicit offers from them. The characteristics of these solicitations are:

- They would be for new development or for major modifications to an existing system for which the Department has a valid requirement.
- The effort must be of sufficiently low risk so offerors can realistically price it in a competitive fixed price environment. There should be evidence of prior risk mitigation. Lengthy, higher risk development efforts may have to be divided into lower risk segments.
- The effort would be solicited on a competitive fixed price basis so there would be no need for submission of any cost or pricing data. When appropriate, the contracts should use the terms, conditions, and procedures under the Federal Acquisition Regulation Part 12, "Acquisition of Commercial Items."
- Only performance should be specified, including any necessary interfaces with other systems.






• Any follow-on production should be planned for manufacture on existing product lines.

I ask each of you to nominate at least one development and/or major modification requirement that you would propose to satisfy using a fixed price contract as I have described. I am enthusiastic about this contracting method as a way to broaden our industrial base and bring fresh new ideas to DoD. I look forward to your nominations.

In the months to come, I will be looking for opportunities to promote additional concepts and welcome your suggestions on how we might further encourage traditionally non-defense companies to participate in the defense segment of a national industrial base.



J. S. Gansler

# Appendix C. Director, Defense Procurement, Memorandum of July 20, 1998



## OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON  
WASHINGTON, DC 20301-3000

July 20, 1998

MEMORANDUM FOR DIRECTOR, DEFENSE ADVANCED RESEARCH PROJECTS AGENCY

SUBJECT: Fixed Price Contracts for Development with Commercial Companies

You explained in your memorandum of July 1, 1998, how research and development (R&D) services on four recent DARPA contracts awarded under Federal Acquisition Regulation (FAR) Part 12, "Acquisition of Commercial Items," satisfy the definition of a commercial item contained in FAR subpart 2.101. In essence, you stated that the R&D services on these contracts are of a type provided by the contractors to commercial clients at established market prices. FAR 35.002 provides, "Unlike contracts for supplies and services, most R&D contracts are directed toward objectives for which the work or methods cannot be precisely described in advance." Unlike other types of services, R&D services are not as likely to have established catalog or market prices available or otherwise be considered commercial services. Based on the information you provided, the R&D services on three of the DARPA contracts do not meet the FAR definition of a commercial item.

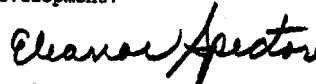
For three of the contracts, your rationale relies upon the R&D services in question being "traded substantially" between each contractor's research center and their respective product divisions. However, such transactions fail to satisfy the requirement of established market prices for specific tasks. When the words "or market" were added to the phrase "established catalog or market prices" (41 U.S.C. 403(12)(F)), the accompanying Conference Report defines market prices as "current prices that are established in the course of ordinary trade between buyers and sellers free to bargain and that can be substantiated from sources independent of the offeror" (H. Rep. 104-450, page 967, emphasis added). For example, in the case cited in your white paper, the Comptroller General found that market prices could be substantiated for international shipments on a moving services contract by using market rates that were established for component services and aggregating them to formulate a "through" rate or market price. Malco Forwarding, Inc., B-277241.8, B-277241.9, 9702 CPD 110 (1997). In discussing whether interdivisional transfers can qualify as a sale in the marketplace, the white paper provides that such is the case when FAR 2.101(f) and (g) are read together. However, FAR 2.101(f) necessarily requires that commercial services are of a type offered and sold in the marketplace in substantial quantities



based on established catalog or market prices as discussed above. Interdivisional transfers alone, therefore, can not satisfy this definition.

The fourth contract apparently involves a small, commercial software development company, which had sufficient sales to qualify under the FAR definition. I would appreciate more information on the specific services procured under this contract and how you verified that the services were sold competitively, in substantial quantities, in the commercial marketplace based on established market prices for specific tasks.

You indicated that the four DARPA contracts included DFARS 252.227-7015, "Technical Data--Commercial Items." Why did DARPA not include a provision that would have given the government rights to technical data generated under the contract, in view of the fact that we are paying for development?



Eleanor R. Spector  
Director, Defense Procurement

# Appendix D. Director, Defense Procurement, Memorandum of October 26, 1999



## OFFICE OF THE UNDER SECRETARY OF DEFENSE:

3000 DEFENSE PENTAGON  
WASHINGTON DC 20301-3000

### EXECUTIVE SUMMARY

MEMORANDUM FOR UNDER SECRETARY OF DEFENSE (ACQUISITION AND TECHNOLOGY)

PRINCIPAL DEPUTY UNDER SECRETARY OF DEFENSE  
(ACQUISITION AND TECHNOLOGY)

FROM: DIRECTOR OF DEFENSE PROCUREMENT *Chauvin Spectator* 10/26/99  
Prepared by Barbara Glotfelty/DSPS/695-4259/990909

SUBJECT: LMI Report (TAB A) on Using FAR Part 12 to Buy  
Research-INFORMATION

PURPOSE: Respond to Dr. Gansler's note (Tab B) and comment on the LMI Study.

DISCUSSION: I think doing appropriate research-related services under FAR Part 12 is a good idea. However, I believe conducting research under FAR Part 12 requires a law change because the law says commercial services must have "catalog or market prices for specific tasks." The law also includes a prohibition on the use of cost type contracts for commercial items. My July 1998 memo (TAB C) asked DARPA for the legal basis for using Part 12 for R&D and how they were obtaining data rights for the R&D we are paying for. (It is a commercial practice to obtain rights in data resulting from R&D that one funds.) LMI may endorse the policy of using Part 12 for the conduct of applied research, but needs legal advice as to the Department's authority for doing so.

Though the report's title focuses on FAR Part 12, the author's primary interest appears to be leveraging commercial research and development through whatever effective means are available. The report repeatedly mentions attracting commercial firms that would not otherwise do business with the government, and facilitating civil/military industrial integration in the R&D arena. These objectives are served by a variety of assistance and acquisition instruments. The ones specifically tailored for these purposes are grants, cooperative agreements, and other transactions (10 U.S.C. Sections 2358 and 2371) for research, which provide far more flexibility than do FAR Part 12 contracts.

If it is decided that applied research, as a class, should be bought under FAR Part 12, that decision in all likelihood would severely limit the use of other transactions for research. Section 2371 provides that the Secretary of Defense shall ensure that other transactions may be used for a research project when the use of a contract, grant, or cooperative agreement is not feasible or appropriate. Therefore, if a FAR Part 12 contract is determined to be "feasible and appropriate" as a blanket rule for certain types of projects, then an other transaction would not be available for the same types of projects.

COORDINATION: DGC(A&L) concurs. See Tab D.



COORDINATION  
9/10/99

SUBJECT: Response to Dr. Gansler's Note and Comment on the  
LMI Report on Using FAR Part 12 to Buy Research

PLEASE REPLY NLT SEPT 10, 1999

SUBJECT:.

After Coordination please call Joyce Martin/ on 695-8569.  
AO: Barbara Glotfelty-695-4259, OUSD(A&T)DP/DSPS, RM 3C762

for  
DGC(A&L)

DATE 22 Oct 99

COMMENTS:

As Edited. Absent a change in the law, applied research does not meet the statutory criteria for commercial services and accordingly does not qualify for contracting under FAR Part 12. We have more flexibility under current law with respect to appropriate research related services.

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## **Appendix E. Report Distribution**

### **Office of the Secretary of Defense**

Under Secretary of Defense for Acquisition, Technology, and Logistics  
Deputy Under Secretary of Defense (Acquisition Reform)  
Director, Defense Procurement  
Under Secretary of Defense (Comptroller)  
Deputy Chief Financial Officer  
Deputy Comptroller (Program/Budget)

### **Department of the Army**

Assistant Secretary of the Army (Acquisition, Logistics, and Technology)  
Auditor General, Department of the Army

### **Department of the Navy**

Assistant Secretary of the Navy (Research, Development, and Acquisition)  
Naval Inspector General  
Auditor General, Department of the Navy

### **Department of the Air Force**

Assistant Secretary of the Air Force (Acquisition)  
Assistant Secretary of the Air Force (Financial Management and Comptroller)  
Auditor General, Department of the Air Force

### **Other Defense Organizations**

Director, Defense Advanced Research Projects Agency  
Director, Defense Contract Audit Agency

### **Non-Defense Federal Organizations**

Office of Federal Procurement Policy  
Office of Management and Budget

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## **Congressional Committees and Subcommittees, Chairman and Ranking Minority Member**

Senate Committee on Appropriations  
Senate Subcommittee on Defense, Committee on Appropriations  
Senate Committee on Armed Services  
Senate Committee on Governmental Affairs  
House Committee on Appropriations  
House Subcommittee on Defense, Committee on Appropriations  
House Committee on Armed Services  
House Committee on Government Reform  
House Subcommittee on Government Management, Information, and Technology,  
Committee on Government Reform  
House Subcommittee on National Security, Veterans Affairs, and International  
Relations, Committee on Government Reform





# Under Secretary of Defense for Acquisition, Technology, and Logistics Comments



ACQUISITION AND  
TECHNOLOGY

DP/DSPS

## OFFICE OF THE UNDER SECRETARY OF DEFENSE

3000 DEFENSE PENTAGON  
WASHINGTON DC 20301-3000

JANUARY 26, 2001

MEMORANDUM FOR DIRECTOR, ACQUISITION MANAGEMENT DIRECTORATE,  
DOD INSPECTOR GENERAL

THROUGH: DIRECTOR, ACQUISITION RESOURCES AND ANALYSIS *LA Lee*  
*1/29/01*

SUBJECT: Evaluation Report on the Use of Federal Acquisition  
Regulation Part 12 Contracts for Applied Research  
(Project No. D2000AE-0272.000)

This is in response to your request of November 27, 2000,  
to provide comments on the subject draft report. Our comments  
are attached. Thank you for the opportunity to comment.

Deidre A. Lee  
Director, Defense Procurement

Attachment:  
As stated

EVALUATION REPORT DATED NOVEMBER 27, 2000  
PROJECT NO. D2000AE-0272.000

"USE OF FEDERAL ACQUISITION REGULATION PART 12  
CONTRACTS FOR APPLIED RESEARCH"

USD(AT&L) COMMENTS

**RECOMMENDATION 1:** We recommend that the Under Secretary of Defense (Acquisition, Technology and Logistics: (1) Provide guidance to the Rapid Improvement Team and DoD contracting officers to: a. Not use a commercial item contract (Federal Acquisition Regulation Part 12, "Acquisition of Commercial Items") to acquire applied research; and, b. Clarify that market research, especially verification of market prices from sources independent of the offeror, is a key factor in determining whether services qualify as commercial items.

**RESPONSE:** Concur with 1.a. The USD(AT&L) will provide guidance on appropriate contract types for applied research. Concur with 1.b.

**RECOMMENDATION 2:** If the decision is made to encourage the use of a new type of contract for research and development under which a fixed amount of funding is established for the contractor to provide its best efforts toward achieving a desired outcome, such as a "firm-fixed-price (variable outcome) contract," then the new contract type should be established in the Federal Acquisition Regulation, along with criteria for and limitations on its use.

**RESPONSE:** Partially concur. We agree in principle that the Department should explore the utility of the type of contract for R&D under which a fixed amount of funding is established for the contractor to provide its best efforts toward achieving a desired outcome. If it has utility, the new contract type should be established in the FAR, along with criteria for and limitations on its use. This will create a common understanding of the contract type, and make it part of every contracting officer's tool kit.

We object only to inclusion of the following words in the Recommendation: "such as a 'firm-fixed-price (variable outcome) contract,'". Though the label has been used, and is referred to in the text of the draft report, the label is a misnomer, and should not be perpetuated by being included in a recommendation

that becomes a tasking. The concept is similar to that of a cost-reimbursement completion type of contract, except that it is the deliverable, rather than the amount to be paid, that is subject to adjustment. In FFP contracts, both the price and the deliverable are "fixed".

**COMMENTS ON THE REST OF THE DRAFT REPORT:**

1. Exec. Summary, "Results". The statement that the Office of General Counsel (and other mentioned offices) advised both the Office of the USD(AT&L) and DARPA "that the use of commercial item contracts for applied research is inappropriate" is not correct in that the advice provided by OGC(A&L) was to the OUSD(AT&L), i.e., DDP, but not to DARPA.

Revised

2. The term "research services" should be deleted from the report, since it is not a synonym for "research", "research and development", or "the conduct of research". Use of the term leads to unnecessary confusion. The issue addressed by this draft report is whether applied research, not undefined "research services", meets the definition of a "commercial item" for the purpose of buying applied research under FAR Part 12.

Revised

3. Page ii, Summary paragraph, last sentence. Change to read: "... such as the 'firm-fixed price (variable outcome) contract' used by Fort Huachuca, ..." The draft report's numerous references to the "FFP (variable outcome)" contract awarded by Fort Huachuca to the contractor inappropriately suggests that the contract is indeed a FFP type of contract. Putting the term in quotation marks indicates the IG is using a term used by others, without endorsing the appropriateness of the label. As described in the report, the "FFP (variable outcome)" contract is not a FFP type of contract. FFP contracts commit the contractor to deliver a defined deliverable item for the FFP, i.e., it is understood to require "guaranteed performance". This is the opposite of agreeing to accept a "variable outcome". To the extent there are advantages to a contract type that establishes a fixed amount of funding to buy best efforts toward achieving a goal or objective, such a contract type can be developed, as suggested in the draft report's second recommendation, but it would not be a contract type in the "FFP" category.

Page ii,  
Revised

4. Page 2, "Methods to Acquire Research and Development". This paragraph needs to be clarified in that Chapter 139 of title 10, United States Code, does not provide authority to "acquire research services," but provides authority in 10 U.S.C. § 2358

Page 2,  
Revised

Page 2,  
Revised

Page 12,  
Revised

Page 15.  
\*Proprietary  
data deleted.

Page 15,  
Revised

to "engage in basic research, applied research, advanced research, and development projects" by contract, grant, or cooperative agreement (consistent with the Federal Grant and Cooperative Agreement Act), and provides authority in 10 U.S.C. § 2371 to enter into "other transactions" to carry out "basic, applied, and advanced research projects." Therefore, the statements about authorizing "acquisitions" should be revised to reflect that the authority to engage in research and development projects and the authority to carry out research projects is provided by Chapter 139 of title 10, U.S.C. This should also be changed in the subsequent paragraphs, "Grants and Cooperative Agreements," and "Other Transactions."

5. Page 2, "Grants and Cooperative Agreements" paragraph. Here and elsewhere in the report, delete the word "acquire" when referring to grants and cooperative agreements. They are assistance instruments, not acquisition instruments. Since many other transactions are used in the assistance arena, the terms "acquire" and "acquisition" are often not appropriate in conjunction with other transactions, either.

6. Page 12, 1<sup>st</sup> full paragraph. Delete the sentence that reads: "The RIT team member from the Office of the Director of Defense Procurement was still deliberating the issue as to whether the Sarnoff effort satisfied the definition of a commercial item when the contracting officer awarded the contract." It is not an accurate description. For the purpose of this paragraph, what matters is that the contract was awarded in spite of various problems, and in spite of known objections of the IG and DCAA. If you consider it necessary to address DDP in this context, substitute: "The RIT team member from the ODDP had not provided an official DDP position on the proposed approach to contracting with the contractor before hearing the contract had been awarded." We were in the process of addressing policy and legal concerns regarding pricing, FAR Part 12, and data rights.

7. Page 15, second-to-last paragraph. While there is not objection to the concept stated that use of FAR Part 12 procedures may result in receiving less research, it is not clear how the " \* less research" was deduced.

8. Page 16, 1<sup>st</sup> paragraph of "FFP (Variable Outcome) Type Contract." Insert as a new second sentence the following, for clarification: "Implicit in this FFP construct is the understanding that for the FFP, the contractor will deliver what

the government contracted for, i.e., a "FFP" is for a fixed outcome."

9. Page 19, last bullet under "Effect of Using FAR Part 12". Change the last sentence to read, "Where research is Government-funded, the Government may have an interest in obtaining greater rights." The DFARS recognizes that in some situations the DoD might not need the rights it is entitled to under the law or regulation and encourages contracting officers to negotiate data rights tailored to fit the needs of the particular procurement. Therefore, the statement that the Government "should" have greater rights is not necessarily correct.

Page 18,  
Revised

10. Page 19, "Other Alternatives" paragraph. In the last sentence, delete "cooperative agreements and grants, where appropriate, and particularly", since the purpose of "other transactions" is to attract commercial companies more so than cooperative agreements and grants, which already are mentioned in the previous sentence. Also, since the context of this paragraph is acquisition rather than assistance, it is not appropriate to refer to assistance instruments.

Page 19,  
Revised

11. Page 19, lead-in under "Improvements in Procurement of Services". In the third sentence, clarify by adding before the final "if", the following: ", even if the service being acquired does not meet the definition of 'commercial service'".

Page 19,  
Revised

12. Page 21, "Conclusion", states that the OUSD(AT&L) "has also advocated, as a price-based acquisition tool, the use of fixed-price (variable outcome) contracts as the preferred approach for science and technology efforts." There is nothing in the body of the report on which this statement is based, nor a reference to the source of this information. The "Conclusion" goes on to state that "a number of DoD components disagreed with the approach and considered [it] either as a return to the 1980's approach of using firm-fixed-price contracts for research and development, or a difficult concept to implement." Again, there is no basis for this statement in the body of the report, and no reference to a source. Either delete these statements from the conclusion, or add to the body of the report information that provides support for them.

Pages 2 and  
20, Revised

13. Page 21, "Conclusion". For consistency, recommend revising the first two sentences by deleting "trying to acquire applied research" and replacing with "trying to engage in applied research projects" and then replacing "Acquisition of applied research" with "The conduct of applied research".

Page 20,  
Revised

## **Evaluation Team Members**

The Acquisition Management Directorate, Office of the Assistant Inspector General for Auditing, DoD, prepared this report.

Thomas F. Gimble  
John E. Meling  
Jack D. Snider  
Jacqueline N. Pugh  
Krista S. Gordon